

Advice from the Experts

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Proposition 13 Turned on its Head - Orange County Court Makes a "Pool" of California's Voters

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A recent decision by an Orange County Superior Court judge demonstrates just how quickly some Californians can forget their own recent history, and the potentially devastating effects that their cultural amnesia can have. In *County of Orange v. Orange County Assessment Appeals Board No. 3* (referred to here as "Pool")^[1], the trial court held that the 2% limitation on annual increases in property tax assessments mandated under Prop. 13 also applies to annual increases in the tax assessments for a property whose assessed value previously was reduced to reflect a cyclical downturn in the local real estate market. The decision - and the Assembly bill^[2] introduced in January, 2002 in an attempt to codify the decision - not only makes a mockery of Prop. 13 but also unwittingly threatens its continued viability.

A Brief History

Let us revisit California in the mid-1970s. Real estate values were sky-rocketing. And as a result of a long-standing practice of alternating and frequent increases in both assessed values and property tax rates, California property owners were faced with spiraling property taxes and, in certain extreme cases, the potential loss of their homes. When attempts to secure a legislative solution failed, the voters took matters into their own hands. In June, 1978, Californians, by an overwhelming majority, passed Proposition 13; its controversial yet simple formula revolutionized the taxation of real estate in California.

Prop. 13 introduced the concept of "acquisition value" into the assessment process and established limits both on assessed value as well as the rate at which taxes on the assessed value are computed. To local governments, the initiative was blasphemy. Scores of counties and certain cities initiated a legal challenge that rapidly made its way to the California Supreme Court. In a decision rendered in September, 1978, the Supreme Court upheld the initiative and the constitutional amendments that were embodied within it. The Court observed that:

"... this 'acquisition value' approach to taxation finds reasonable support in a theory that the annual taxes which a property owner must pay should bear some rational relationship to the original cost of the property, rather than relate to an unforeseen, perhaps unduly inflated, current value. Not only does an acquisition value system enable each property owner to estimate with some assurance his future tax liability, but also the system may operate on a fairer basis than a current value approach."^[3]

The Court validated the desire of millions of property owners to gain a measure of predictability by creating a direct connection between the amount they were willing to pay to purchase or to



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improve their property and their maximum property tax liability, thereby eliminating any tax impact of quixotic spikes in a property's market value.

The legislature quickly enacted a statutory scheme that reflected the simplicity of Prop. 13. A property's acquisition value became its "base year value," which would establish the upper limit on a property's assessed value. The base year value of every California property was set at its previously assessed value for the 1975-76 tax year, arbitrarily designated in the initiative as the starting point. That value (increased annually, as discussed below) would remain in effect unless and until there was a change of ownership or new construction with respect to the property. At such time, a new base year value would be set that reflected the then-current acquisition value - as evidenced by the price paid to purchase the property or the cost of the new improvements to it. Once a base year value was established, it thereafter could be increased ("indexed," in the parlance of Prop. 13) by not more than 2% annually^[4]. Finally, the amount of the resulting tax was limited to 1% of a property's assessed value.

Simplicity has its limitations, however. The legislature realized that Prop. 13, in its single-minded focus on seemingly ever-increasing property values and property taxes, had created uncertainty as to whether a property's assessed value could ever be decreased. So in November, 1978, Proposition 8, an initiative sponsored by the legislature to address this apparent ambiguity, was readily approved by the voters. Prop. 8 confirmed that the establishment of a property's base year value under Prop. 13 does not preclude a subsequent reduction in its assessed value to reflect damage or destruction caused by disaster, misfortune or calamity or other factors causing a decline in its market value.

Seen in an historical context, Prop. 8 was nothing more than a reaffirmation that Prop. 13's acquisition value approach merely sets the upper limit on a property's assessed value. Lost in the hysteria over Prop. 13 was the fact that the "fair market value" standard that had governed property tax assessment in California for over a century^[5] was not repealed by the initiative.

Accordingly, if a property should suffer damage by fire, destruction by earthquake or even devaluation by reason of its physical obsolescence or market conditions and, as a result, its fair market value is lowered below its "acquisition value," i.e., its indexed base year value, Prop. 13 did not deprive the owner of the right to have the property assessed at the lower, fair market value. And while Prop. 13 imposed not only an acquisition value limitation on a property's assessed value but also a 2% ceiling on annual increases to that limitation, neither Prop. 13 nor Prop. 8 created any such limitation on reductions in assessed value.

The Pool decision effects a perverse revision of this history. Seizing on nothing more than a single phrase in the constitutional amendment adopted after passage of Prop. 13 and amended to reflect the intent of Prop. 8, the trial court took Prop. 13's 2% ceiling on annual increases in the acquisition value limitation - clearly intended to protect property owners against the effects of market inflation -- and superimposed it on subsequent annual increases in assessed values that, under Prop. 8, have been reduced as a result of market deflation. In effect, the court created a "super" Prop. 13, with an across the board 2% limit on annual increases in assessed value. Neither the history of the initiatives nor the constitutional amendments, statutes and regulations that have been adopted to implement the propositions support this distortion of Prop. 13's acquisition value approach to property taxation.

Constitutional/Statutory Framework

In almost a quarter-century since passage of Propositions 13 and 8, the legislature and the courts have developed an extensive body of implementing statutes, regulations and laws. There are only a handful that specifically address the issue raised in the Pool decision, however. A review of these enactments reveals that with the exception of an occasional misuse of a defined phrase^[6] and minor ambiguities, the history and intent of both Prop. 13 and Prop. 8 are clearly and consistently manifested. And there is nothing in the legislative or judicial framework on which to base this judicial rewrite of recent California history.

- A. **California Constitution Article XIII A** is the constitutional amendment mandated by Prop. 13. It was adopted in June, 1978 and amended in November, 1978 to reflect the clarifications addressed in Prop. 8. Section 1 (with certain exceptions not germane to this discussion) sets the limitation on property taxes at 1% of a property's "full cash value"^[7]. The base year value, i.e., acquisition value, concept at the heart of Prop. 13 is embodied in Section 2. Section 2(a) contains the definition of base year value (referred to as "full cash value" in the provision). Section 2(b) sets forth the 2% limitation on annual indexing of the base year value. As amended after passage of Prop. 8, this provision also affirms the right of an owner to secure a reduction in the assessed value of a property when the fair market value of the property declines below its indexed base year value. The Pool court based its decision entirely upon the awkward wording of this provision:

"(b) The full cash value base may reflect from year to year the inflationary rate not to exceed 2 percent for any given year or reduction as shown in the consumer price index . . . , or may be reduced to reflect substantial damage, destruction or other factors causing a decline in value." (Italics supplied.)

- B. **California Constitution Article XIII** embodies the basic standards applicable to the taxation of all property in California. It was not repealed or superceded by Article XIII A. Section 1(a) is the only portion relevant to this discussion. It provides that all real property shall be assessed at 100% of its "fair market value" unless "a value standard other than fair market value is prescribed by this Constitution," i.e., the acquisition value limitation imposed under Article XIII A, in which case the property's assessed value shall equal 100% of the alternative value standard. It is essential to read this provision in conjunction with Article XIII A: even after passage of Prop. 13, real property must be assessed at 100% of its "fair market value" unless and until that value exceeds the acquisition value limit mandated by the initiative. Stated another way, if a property's fair market value is less than its indexed base year value, the annual assessment is limited to its fair market value. (The author believes that Prop. 8 simply affirmed the continued viability of Article XIII after passage of Prop. 13, although that point surely was lost in the attention focused on the brand new Article XIII A.)
- C. **Rev. & Tax. Code Section 110** sets forth the standards for determining a property's "fair market value" or "full cash value" under Article XIII of the Constitution.

Subsection (a) equates "full cash value" with the traditional appraisal concept of fair market value - the price that a hypothetical buyer would pay in cash in an arm's length transaction after the property has been exposed for sale to the open market. Subsection (b) creates a presumption that the purchase price paid for a property is its fair market value or full cash value as of the date of purchase.

- D. **Rev. & Tax. Code Section 110.1** embodies the Prop. 13 concept of acquisition value, i.e., "base year value." It defines a property's base year value as its fair market value, determined pursuant to Section 110, either as the 1975 lien date^[8] or, for property which is purchased or is newly constructed after the 1975 lien date, as of the date on which the purchase occurs or the date on which new construction is completed. Subsection (f) authorizes the annual increase, or indexing, of the base year value "determined pursuant to [Section 110.1]," subject to the 2% limitation set forth in Article XIII A.2(b) and Rev. & Tax. Code Section 51 (discussed below). Nothing in the provision suggests that the value that is subject to annual indexing is other than the acquisition value, i.e., initial base year value.
- E. **Rev. & Tax. Code Section 51** addresses adjustments to base year values and confirms the interplay between Articles XIII and XIII A of the Constitution. The section provides that for each lien date after the lien date on which a property's base year value is determined under Section 110.1, the assessed value of the property will be the lesser of two values: (i) its "base year value" compounded annually since the initial base year by an inflation factor limited to 2% per year (the Prop. 13 upper limit) or (ii) its "full cash value," as defined in Section 110 (the Art. XIII basic standard), as of the applicable lien date, "taking into account reductions in value due to damage, destruction, depreciation, obsolescence, removal of property or other factors causing a decline in value." (*Italics supplied.*) For real property "damaged or destroyed by disaster, misfortune or calamity" (but not property merely impacted by a cyclical downturn in value), it provides for a temporary reduction in its base year value pending restoration, repair or reconstruction. Finally, the statute expressly requires that any property whose assessed value has been reduced, for any of the reasons specified in (ii) above, to reflect a full cash value that is less than its indexed base year value thereafter shall be reassessed annually at its "full cash value" until that value exceeds the indexed base year value described in (i) above.
- F. **Cal. Code of Regulations Rule 461** deals with declines in value. Under subsections (d), (e) and (f), the assessed value of a property that has declined in value (without regard to cause) is determined by comparing the full cash value of the property on a particular lien date to the indexed base year value as of that lien date and then enrolling the lesser of the two values. The rule confirms that under Prop. 13, in no event may the assessed value of a property on any lien date exceed its indexed base year value as of that lien date.

There is nothing in this constitutional and statutory framework, other than the italicized language in Article XIII A.2(b), that lends

any support to the Pool decision. A review of the court's decision demonstrates the illusory nature of that purported authority.

The Folly of Pool

The history and intent of Prop. 13 are well-documented. As a result, the essence of the legislative enactments adopted in 1978 and 1979 (discussed above) to implement the initiative has remained, in large part, intact. The judge apparently gave little weight to that history and made no discernable effort to ascertain the intent of either the voters or the legislature. Instead, the court focused on the language of Article XIII 2(b) of the Constitution (discussed above). On the basis of the phrasing of that provision, coupled with a complete misreading of Rev. & Tax. Code Section 51, the court extrapolated an "intent" of the initiatives: in no event would any tax increase exceed 2% per year (except in situations not presented by the facts of the case) (emphasis in original). Maybe property tax law is a bit confusing or perhaps plaintiff's counsel was glib, but imposition of a limitation that had never arisen in the more than two decades since passage of Prop. 13 - without any real inquiry into the history and intent of the initiative or the legislation - underscores why judges make bad legislators.

The court clearly was confused. It noted that both Prop 13. and Prop. 8 offered the "promise" of not just a "long-term limit" but also a "short-term limit" to property taxation. It was correct as to Prop 13. - the long-term limit, as represented by the acquisition value limitation, and the short-term limit, as embodied in the 2% annual "cap." But there is nothing in Prop.8 that even hints at limits. The initiative affirmed a property owner's right to have a property's assessed value lowered in the event its fair market value, on any applicable lien date, has fallen below its indexed Prop. 13 base year value. And, as discussed above, there was no mention of a lower limit, i.e., a "floor," on reductions in a property's assessed value under Prop. 8

While at first glance the decision may seem very favorable to property taxpayers, its return to the vagaries of the pre-Prop. 13 "market" system is anything but auspicious. The acquisition value approach upheld by the California Supreme Court has three elements - a base year value, permitted indexing of that base year value and a limitation on the permissible tax rate. As a result, taxes paid by California property owners bear "some rational relationship to the original cost of the property." Under the Pool rationale, acquisition value would be completely supplanted, but only in the event of downward (not upward) fluctuations in the "market." In essence, a classic "I win, you lose" scenario. Nothing in either Prop. 13 or Prop. 8 even remotely infers that intent.

Many Californians have forgotten the antipathy with which Prop. 13 was greeted by some citizens and most local government agencies. Notwithstanding that hostility, Prop. 13 and Prop. 8 have engendered a property tax system in California that is, on balance, fair. The Pool decision, and its legislative progeny, would eliminate any semblance of fairness in the assessment process: in a rising "market," a property owner would still be protected by the 2% limitation on annual increases in acquisition value, while in a falling "market," that same owner could obtain an assessment reduction of 5%, 10% or more in one tax year and then use the 2% limitation to lock-in that "market" driven reduction for subsequent tax years! It was precisely that permeating sense of unfairness, albeit in the opposite direction, that set the stage for Prop. 13.

Conclusion

For almost a quarter-century, Prop. 13 has restrained California assessors from increasing a property's assessed value beyond its indexed base year value, even when annual "market" value increases have reached double digits. They also have been compelled by Prop. 8 to reflect decreases in "market" value, even double-digit declines, by assessing a property at its fair market value when that value goes below its indexed base year value. In myopically seizing on a single ambiguity in an extensive legislative framework, the Pool decision grafts the voter-approved 2% limit on annual increases in acquisition value onto annual increases in a "market" value that has no relationship to the original cost of the property. Such a radical revision of the history and intent of Props. 13 and 8 must be left not to the courts or the legislature, but to the voters who approved the initiatives - after careful consideration of all the consequences.

Footnotes:

1. County of Orange vs. Orange County Assessment Appeals Board No. 3 (Robert A. Pool and Renee M. Bezaire, Real Parties in Interest), Orange County Superior Court action no. 00CC03385, decided November 2, 2001. The action involves an appeal by homeowners Pool and Bezaire of the 1998-1999 assessment of their home in Seal Beach, California. Pool, an attorney, apparently is also a partner in the law firm representing the taxpayers, who are seeking certification of the proceeding as a class-action on behalf of similarly-situated taxpayers.

2. Assembly Bill 1315, as amended in the Assembly January 10, 2002, was introduced by Assembly Member Sally Havice, D-Bellflower.

3. Amador Valley Joint Union High School District v. State Board of Equalization (Sept. 1978) 22 Cal. 3rd 208; 149 Cal. Rptr. 239.

4. While the maximum annual increase in the acquisition value, i.e., base year value, is two percent (2%), the actual percentage increase permitted under Rev. & Tax. Code Section 51 (a) is tied to the California Consumer Price Index (hence the references to "indexed base year value"). In only a few years since passage of Prop. 13 has the permissible increase been less than 2%.

5. Article XIII was included in the California Constitution of 1879. It was extensively revised by an amendment adopted in 1974. The language of Section 1 (discussed in section 2.B of this article) has remained unchanged since that time.

6. The California Constitution, Rev. & Tax. Code, Code of Regulations and related enactments contain a multitude of value concepts and phrases, e.g., "full cash value," "fair market value," "full value," "appraised value," "base year value," "indexed base year value" and even "full cash value base." Not surprisingly, within this extensive legislative scheme, there are isolated instances of inconsistent or ambiguous use of the terms.

7. The 1% tax rate limitation set forth in Section 1(a) of Article XIII A applies to all ad valorem taxation of real property - irrespective of whether the assessed value is the "indexed base year value" determined under Prop. 13 or the "fair market value" affirmed by Prop. 8.

8. Under California's property tax scheme, the lien of ad valorem taxes attaches against a property annually as of 12:01 a.m. on the first day of January (prior to January, 1997, it was March) preceding the fiscal year for which the taxes are levied. (Rev. & Tax. Code Section 2192.) The "1975 lien date" was March 1, 1975, for the 1975-1976 fiscal year.

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